**JOSEPH KELLY**
TREASURER AND TAX COLLECTOR

# COUNTY OF LOS ANGELES
## TREASURER AND TAX COLLECTOR

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February 23, 2016

TO: Supervisor Hilda L. Solis, Chair
Supervisor Mark Ridley-Thomas
Supervisor Sheila Kuehl
Supervisor Don Knabe
Supervisor Michael D. Antonovich

FROM: Joseph Kelly
Treasurer and Tax Collector

SUBJECT: **FITCH RATINGS UPGRADE**

On February 22, 2016, Fitch Ratings raised the County's issuer credit rating from AA- to AA. The upgrade to an AA rating follows a comprehensive multi-year effort by my Department to educate the three major credit rating agencies on the improved financial condition of the County. In their ratings report, Fitch attributed the credit ratings upgrade to the County's improving revenue growth, strong financial management, healthy financial reserve levels, stabilization of General Fund subsidies to the Department of Health Services, and the ongoing progress toward addressing unfunded pension and OPEB liabilities.

The Fitch credit ratings upgrade was provided in connection with the issuance of the Public Works Financing Authority Lease Revenue Bonds, 2016 Series D (the "Bonds"), which was approved by your Board on February 16, 2016. The Bonds are currently scheduled to price during the week of February 29, 2016, with closing scheduled for March 17, 2016. The ratings upgrade by Fitch reflects the strong financial condition and credit quality of the County, which is the direct result of your Board's prudent and effective long-term fiscal stewardship. A press release from Fitch announcing the ratings upgrade is attached for your reference.

Also attached to this memorandum is a chart that details the positive rating actions undertaken by each of the three major credit rating agencies since 2007.

Should you have any questions regarding the credit ratings or the issuance of the Bonds, please contact me directly or your staff may contact John Patterson, Senior Finance Analyst, at (213) 974-2310 or jpatterson@ttc.lacounty.gov.

JK:JP:GH:pab
Pb/jk/bosratingmemo

Attachments

C: Chief Executive Officer
Auditor-Controller
Acting Executive Officer, Board of Supervisors
Dr. Mitchell Katz

FitchRatings

# Fitch Rates LA County Public Works Financing Authority, CA LRBs 'AA-'; Upgrades Outstanding Ratings

Fitch Ratings-San Francisco-23 February 2016: Fitch Ratings has assigned an 'AA-' rating to the following Los Angeles County Public Works Financing Authority (the authority), California lease revenue bonds:

--$246.3 million lease revenue bonds, 2016 series D.

The bonds will be sold via negotiation during the week of Feb. 29, 2016.

In addition, Fitch upgrades the following outstanding ratings:

--Implied county ULTGO bond rating to 'AA' from 'AA-';
--$66.1 million county COPs, series 1993 Disney Parking Project and 2012 refunding COPs (Disney Concert Hall Parking Garage) to 'AA-' from 'A+';
--$22.7 million Los Angeles County Capital Asset Leasing Corporation lease revenue bonds (LAC-CAL Equipment Program), series 2011A and 2014A to 'AA-' from 'A+';
--$1.4 billion Los Angeles County Public Works Financing Authority lease revenue bonds (multiple capital projects), 2010 series A (tax-exempt) and series B (Build America Bonds), lease revenue bonds (multiple capital projects II), series 2012, lease revenue bonds (multiple capital projects), series 2015A, and lease revenue bonds (master refunding project), series 2015B (tax-exempt) and 2015C (federally taxable) to 'AA-' from 'A+';
--$66.4 million Sonnenblick-Del Rio El Monte Asset Leasing Corporation senior COPs, series 1999 (Department of Public Social Services Facility) and series 2001 (Department of Public Social Services Facility - Phase II) to 'A+' from 'A';
--$31.6 million Sonnenblick-Del Rio West Los Angeles Leasing Corporation senior COPs, series 2000 (Department of Public Social Services Facility) to 'A+' from 'A'.

The Rating Outlook is revised to Stable from Positive.

SECURITY
Repayment of the 2016 series D bonds is from the county's annual lease rental payments to the authority, payable from legally available funds under a covenant to budget and appropriate, subject to abatement.

KEY RATING DRIVERS

SOLID FINANCIAL MANAGEMENT: The ratings upgrade reflects the county's well-managed financial operations, with strong general fund balances throughout the economic cycle, and strengthened reserve policies.

ONGOING GENERAL FUND SUPPORT FOR HEALTH SYSTEM: The performance of the county's Department of Health Services' (DHS) continues to benefit from wider health sector reform, a five-year extension of the federal hospital financing waiver, and internal changes. Fitch expects that DHS will continue to need general fund support at a significant but stable and sustainable level.

SIGNIFICANT LONG-TERM LIABILITY EXPOSURE: While the county has a moderate overall debt burden, it faces large unfunded accrued actuarial liabilities (UAAL) for its pensions and other-post employment benefits (OPEB). A new OPEB funding policy is a credit positive.

LOCAL ECONOMY CONTINUES TO IMPROVE: The county's vast economy and tax base is vulnerable to economic cycles despite its diversity and maturity. Economic indicators are somewhat mixed, but the tax base and revenue streams continue to grow.

LEASE DEBT RATING DISTINCTION: The one-notch rating distinction between the county's implied ULTGO rating of 'AA' and the 'AA-' rating on the majority of its lease revenue bonds represents the county's covenant to budget and appropriate for lease payments, subject to abatement. There is a further one-notch distinction ('A+') for non-standard leases for Department of Social Services buildings which the county leases but does not purchase, resulting in an increased non-appropriation risk.

RATING SENSITIVITIES
The ratings are sensitive to fundamental changes in financial operations, general fund balances, reserves, liabilities, and the level of general fund support for DHS. The Stable Outlook reflects Fitch's expectation that the county will maintain its current solid financial profile.

CREDIT PROFILE

SOLID FINANCIAL MANAGEMENT
The implied long-term ULTGO rating of 'AA' reflects the county's diverse and mature economy, moderate debt burden, sound financial reserves, and prudent management efforts to successfully maintain fiscal balance amid ongoing and sizable financial pressures. These pressures stem from a heavy social service spending burden, state funding changes, DHS cash flow issues, a large unfunded pension liability, and a costly retiree medical program.

The county ended fiscal 2014 with a surplus for the third consecutive year, increasing the unrestricted general fund balance to $2.862 billion (18.2 % of spending) from the prior year's $2.790 billion (18.1%). These results follow a pattern of notably stable county financial operations throughout the most recent economic downturn.

The county is currently projecting another general fund surplus in fiscal 2016 (year ending June 30). Consequently, the total general fund balance is projected to improve from $3.190 billion in fiscal 2015. In fiscal 2016 to date, both general fund revenues and expenditures reportedly are coming in as budgeted.

The county is expecting to benefit from further revenue growth in fiscal 2017, particularly related to property and sales tax revenues. However, these gains will be at least partially offset by personnel cost increases. The county has agreed to 10% salary increases for most classifications which will be implemented incrementally between October 2015 to April 2018 (at an annual cost of approximately $150 million); fringe benefit increases for certain classifications will cost an additional $35-$40 million annually through fiscal 2019. The county notes that its expenditure flexibility is protected by a steady employee vacancy rate.

The county's rainy day reserve fund is now $337.7 million. The county remains committed to achieving its reserve goal of 10% of ongoing locally generated revenues (currently equivalent to approximately $539 million) through the annual allocation of at least 10% of surplus revenues to either the rainy day reserve fund and/or the county's OPEB trust.

In September 2014, the county added a budget policy requiring the annual appropriation of 5%-10% of new ongoing discretionary revenues to a contingency reserve, with any unused monies at the end of the year transferred to the rainy day reserve fund and/or the OPEB trust. As part of the county's fiscal 2016 adopted budget, $15.9 million was set aside in the contingency reserve (5% of discretionary revenues) and a further $5 million was allocated for deferred maintenance needs. The county's general fund liquidity has been gradually improving in recent years and it has sizeable funds available for intrafund borrowing, if needed (a projected $3.955 billion in January 2016).

DHS FINANCIALS IMPROVING BUT GENERAL FUND SUPPORT STILL REQUIRED
The county projects that DHS will end fiscal 2016 with a fund balance at least comparable to its fiscal 2015 ending balance of $350 million, representing its seventh consecutive year of improved year-end financial results. This is the result of more stable revenue streams, stable contributions from the general fund, improved patient demographics under health care reform, and significant operational changes.

In fiscal 2016, the net county contribution is $635.5 million or 15.5% of the total DHS budget. By contrast, the net county contribution peaked in fiscal 2008 at $827.7 million or 18.2% of the total DHS budget. The net county contribution increases in fiscal 2016 compared to fiscal 2015 ($561 million) because board policy allows DHS to retain savings generated from the state's redirection of less realignment revenues to social services under Assembly Bill (AB) 85. Regarding AB 85, $100 million is being redirected by the state to social services programs in fiscal 2016, much less than the $238.3 million redirected in fiscal 2015. (Both amounts could be adjusted under a two-year reconciliation process.) The county has successfully negotiated with the state not to redirect further monies in fiscal 2017, which will be a boost to DHS funding.

The county expects general fund cash flow loans to DHS to decline to between $500 and $600 million outstanding per year. Fiscal 2015 ended with an unusually low $419.6 million in outstanding general fund loans, down from $870.7 million a year prior and a fiscal 2011 peak of $1.049 billion; the reduction was due to improved DHS cash flows and fund balance. To date, each month in fiscal 2016 has required considerably smaller loans year-over-year; however, the county is expecting to end the year with around $550 million in outstanding general fund loans, more in line with its forward projections.

DHS pressures continue to be partially alleviated by the extension of a federal section 1115 waiver through Dec. 31, 2020 (renamed 'Medi-Cal 2020'). The county does not expect that DHS's budget will be materially impacted by lower funding levels under Medi-Cal 2020 as the maximum reduction is projected to be approximately $55 million in any one year from fiscal 2016 forward.

SIGNIFICANT LONG-TERM LIABILITY EXPOSURE
The county's overall debt burden is a moderate $3,528 per capita or 2.7% of market valuation. Principal amortization is above average at an estimated 64% in 10 years. No long-term debt issuances are currently planned until fiscals 2019 and 2020.

The county faces sizeable long-term unfunded pension and OPEB liabilities. As of June 30, 2015, the county's net pension liability was $6.957 billion. On an actuarial basis, the June 30, 2015 funded ratio was 83.3% using the county's 7.5% assumed rate of return. This does not recognize $980 million of deferred investment gains still to be smoothed in. Fitch estimates the funded ratio at 81.2% when adjusted to reflect a more conservative 7% rate of return. The county's cash contributions to the pension system, which are equal to the annually required contribution (ARC), are budgeted at $1.376 billion in fiscal 2016, after years of steady growth. The county's fiscal 2017 pension contributions are projected to decrease by $74 million due to smoothing in investment gains.

The county also has a $27.3 billion UAAL for OPEB (July 1, 2014), which it has begun to address by establishing an OPEB trust. At its current balance of $530 million, the trust funds approximately 1.9% of the outstanding OPEB liability. The county aims to increase its OPEB trust funding from future surplus revenues. The fiscal 2016 adopted budget includes a $24 million contribution to the OPEB trust. Additionally, in January 2016 $50 million was transferred from excess in the pension system's retiree health premium reserve. Going forward, the county has enacted a new policy to increase its annual OPEB contributions to $60 million annually until the actuarially required annual contribution is fully funded from fiscal 2028 onwards. The $60 million will consist of $25 million general fund monies plus $35 million from federal and state subventions.

The combined carrying costs for debt service, pension ARC, and OPEB pay-go in fiscal 2015 were manageable at 14.3% of total governmental spending.

LOCAL ECONOMY CONTINUES TO IMPROVE
The county's unemployment rate (5.8% in December 2015) is in line with the state's (5.8%) and remains somewhat higher than the nation's (4.8%). Growth in both employment opportunities and the labor force has brought the unemployment rate down from 7.5% a year prior. The county's socioeconomic characteristics are below average relative to the state and somewhat mixed relative to the nation.

Due to the county's highly developed and mature nature, taxable assessed valuation (TAV) losses were relatively small at 0.5% and 1.9% in fiscal years 2010 and 2011, respectively, indicating a significant Proposition 13 cushion. In the subsequent five years, the property market has rebounded by 21.4% through fiscal 2016, with further 5% growth projected for fiscal 2017. This strong TAV growth is supported by a combination of rising house prices, increased construction, decreasing defaults and foreclosures, Proposition 8 TAV restorations, ownership changes, and healthier commercial and industrial real estate markets.

ESSENTIAL ASSETS
The 2016 series D bonds are on parity with 2015 series A, B, and C bonds (rated 'AA-' by Fitch); they have the same bondholder protections and share a pool of leased assets. All 13 leased facilities provide essential county services and include courthouses, a sheriff station, a library, county department buildings, the civic center heating and refrigeration plant, and various components of the Martin Luther King Jr. Community Hospital. Their combined value of an estimated $860.2 million comfortably exceeds the outstanding cumulative par amount of the parity bonds ($605.3 million).

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Additional information is available at 'www.fitchratings.com'.

Fitch recently published exposure drafts of state and local government tax-supported criteria (Exposure Draft: U.S. Tax-Supported Rating Criteria, dated Sept. 10, 2015 and
Exposure Draft: Incorporating Enhanced Recovery Prospects into U.S. Local Tax-Supported Ratings, dated Feb. 2, 2016). The drafts include a number

of proposed revisions to existing criteria. If applied in the proposed form, Fitch estimates the revised criteria would result in changes to less than 10% of existing tax-supported ratings. Fitch expects that final criteria will be approved and published in the first quarter of 2016. Once approved, the criteria will be applied immediately to any new issue and surveillance rating review. Fitch anticipates the criteria to be applied to all ratings that fall under the criteria within a 12-month period from the final approval date.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from CreditScope and Lumesis.

**Applicable Criteria**
Exposure Draft: Incorporating Enhanced Recovery Prospects into US Local Tax-Supported Ratings (pub. 02 Feb 2016) (https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=875108&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJleHAiOjE0NTYzMDc1OTQsInNlc3Npb25LZXkiOiIzTUExREtMNzFNRzNTSFJHWEFaUFU5RFJLU1
Exposure Draft: U.S. Tax-Supported Rating Criteria (pub. 10 Sep 2015) (https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869942&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJleHAiOjE0NTYzMDc1OTQsInNlc3Npb25LZXkiOiIzTUExREtMNzFNRzNTSFJHWEFaUFU5RFJLU1
Tax-Supported Rating Criteria (pub. 14 Aug 2012) (https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJleHAiOjE0NTYzMDc1OTQsInNlc3Npb25LZXkiOiIzTUExREtMNzFNRzNTSFJHWEFaUFU5RFJLU1
U.S. Local Government Tax-Supported Rating Criteria (pub. 14 Aug 2012) (https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=685314&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJleHAiOjE0NTYzMDc1OTQsInNlc3Npb25LZXkiOiIzTUExREtMNzFNRzNTSFJHWEFaUFU5RFJLU1

**Additional Disclosures**
Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/creditdesk/press_releases/content/ridf_frame.cfm?pr_id=999866&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJleHAiOjE0NTYzMDc1OTQsInNlc3Npb25LZXkiOiIzTUExREtMNzFNRzNTSFJHWEFaUFU5RFJLU1
Solicitation Status (https://www.fitchratings.com/gws/en/disclosure/solicitation?pr_id=999866)
Endorsement Policy (https://www.fitchratings.com/jsp/creditdesk/PolicyRegulation.faces?context=2&detail=31)

# LOS ANGELES COUNTY HISTORICAL LONG-TERM RATINGS -- FY 2007 to 2016

| | ISSUER RATINGS (General Obligation Bonds) | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **FYE June 30** | **2007** | **2008** | **2009** | **2010** | **2011** | **2012** | **2013** | **2014** | **2015** | **2016** |
| **Fitch** | Not Reported | Not Reported | Not Reported | Not Reported | AA- | AA- | AA- | AA- | AA-<br>Outlook changed to Positive from Stable | AA |
| **Moody's** | Aa3 | Aa3 | Aa3 | Aa2 | Aa2 | Aa2 | Aa2 | Aa2 | Aa2 | Aa2 |
| **S & P** | AA- | AA- | AA- | AA- | AA-<br>Outlook changed from Stable to Positive | AA | AA<br>Outlook changed to Stable from Positive | AA+ | AA+ | AA+ |

| | LEASE RATINGS (Lease Revenue Bonds) | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **FYE June 30** | **2007** | **2008** | **2009** | **2010** | **2011** | **2012** | **2013** | **2014** | **2015** | **2016** |
| **Fitch** | A | A | A | A+ | A+ | A+ | A+ | A+ | A+ | AA- |
| **Moody's** | A2 | A2 | A2 | A1 | A1 | A1 | A1 | A1 | A1 | A1 |
| **S & P** | A+ | A+ | A+ | A+ | A+ | A+ | AA- | AA | AA | AA |

**LEGEND:**

| | Long-Term Rating Equivalency Scale | | | | | | |
|---|---|---|---|---|---|---|---|
| **Fitch** | AAA | AA+ | AA | AA- | A+ | A | A- |
| **Moody's** | Aaa | Aa1 | Aa2 | Aa3 | A1 | A2 | A3 |
| **S & P** | AAA | AA+ | AA | AA- | A+ | A | A- |

**Higher** **Lower**

*** Areas highlighted in yellow represent a positive rating change**